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In the Supreme Court of the United States

OCTOBER TERM, 1928

No. 129

UNITED STATES OF AMERICA

v.

BOSTON & MAINE RAILROAD

No. 130

OLD COLONY TRUST COMPANY ET AL., EXECUTORS

v.

COMMISSIONER OF INTERNAL REVENUE

ON CERTIFICATE FROM THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FIRST CIRCUIT

BRIEF FOR THE UNITED STATES AND THE COMMISSIONER OF INTERNAL REVENUE

OPINIONS BELOW

The opinion of the District Court in No. 129 is reported in 23 F. (2d) 343.

The opinion of the Board of Tax Appeals, which is the only previous opinion in case No. 130, is found in 7 B. T. A. 648.

JURISDICTION

These cases are here on certificate under Section 239 of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTION PRESENTED

In No. 129 the Fitchburg Railroad Company leased its property to the Boston & Maine Railroad Company, which, pursuant to the terms of the lease, paid the taxes assessed upon the Fitchburg Company's income.

In No. 130 the American Woolen Company, pursuant to a resolution of its Board of Directors made in advance, paid the income taxes assessed upon the salary of its President, William M. Wood. The question is, did the taxes thus paid constitute additional taxable income of the lessor and of the employee, respectively? The question was certified by the court in the following form:

> Did the payment by the lessee in No. 2235 (129) or by the employer in No. 2218 (130) of the income taxes assessable against the lessor in the first case and the employee in the second constitute additional taxable income to such lessor or to such employee?

STATUTES INVOLVED

The Revenue Act of 1917, c. 63, 40 Stat. 300, 333, Section 1206, amends Section 10 of the Revenue Act of 1916, c. 463, 39 Stat. 756, 764, to read:

> SEC. 10. (a) That there shall be levied, assessed, collected, and paid annually upon

the total net income received in the preceding calendar year from all sources by every corporation, * * * a tax of two per centum upon such income; * * *.

The Revenue Act of 1917 also made the following provisions:

SEC. 4. That in addition to the tax imposed by subdivision (a) of section ten of such Act of September eighth, nineteen hundred and sixteen, as amended by this Act, there shall be levied, assessed, collected, and paid a like tax of four per centum upon the income received in the calendar year nineteen hundred and seventeen and every calendar year thereafter, by every corporation, * * *.

SEC. 201. That in addition to the taxes under existing law and under this act there shall be levied, assessed, collected, and paid for each taxable year upon the income of every corporation, partnership, or individual, a tax (hereinafter in this title referred to as the tax) equal to the following percentages of the net income:

* * * * *

Section 213 (a), Revenue Act of 1918, c. 18, 40 Stat. 1057, 1065, provides as follows:

SEC. 213. That for the purposes of this title (except as otherwise provided in section 233) the term "gross income"—

(a) Includes gains, profits, and income derived from salaries, wages, or compensation for personal service (including in the case of the President of the United States,

> the judges of the Supreme and inferior courts of the United States, and all other officers and employees, whether elected or appointed, of the United States, Alaska, Hawaii, or any political subdivision thereof, or the District of Columbia, the compensation received as such), of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. * * *

Section 214 (a) (3), Revenue Act of 1918, provides as follows:

> SEC. 214. (a) That in computing net income there shall be allowed as deductions:
>
> * * * * * *
>
> (3) Taxes paid or accrued within the taxable year imposed (a) by the authority of the United States, except income, war-profits and excess-profits taxes; * * *.

STATEMENT OF FACTS

The facts in No. 129 as certified by the Circuit Court of Appeals (R. 1–2) are as follows:

> This action is brought by the Boston & Maine Railroad to recover income taxes for the year 1917, claimed to have been erroneously collected. In the District Court

the plaintiff recovered a judgment for the full amount of its demand—$3,920.55 and interest.

June 30, 1900, the Fitchburg Railroad Company leased all its railroad and property of every description to the Boston & Maine Railroad for the term of ninety-nine years. In the lease the lessee covenanted to pay specified rentals, to maintain and replace the leased properties in manner indicated, to pay all operating expenses, and to pay "all taxes of every description, Federal, State, and municipal, upon the lessor's property, business, indebtedness, income, franchises, or capital stock, or said rental," and to pay divers other charges. In 1918 an income-tax return, under the provisions of the revenue acts of 1916 and 1917, was filed on behalf of the Fitchburg Railroad Company for the calendar year 1917, upon which taxes amounting to $61,422.06 were assessed. These taxes were paid to the Commissioner of Internal Revenue by the Boston & Maine Railroad pursuant to the term of the lease. The Fitchburg Railroad Company was consolidated with the Boston & Maine Railroad in 1919.

In 1921 the Commissioner of Internal Revenue assessed an additional income tax against the Fitchburg Railroad Company of $3,920.55. In doing this he treated the payment of $61,422.06 made by the Boston & Maine Railroad to the collector of internal revenue as additional taxable income to the

Fitchburg Railroad Company to the extent of $65,342.61. This additional tax of $3,920.55 was paid to the collector of internal revenue by the Boston & Maine Railroad in July, 1921.

The claim for refund of this additional tax was duly filed with the Commissioner of Internal Revenue, but was never formally acted upon, and more than six months having elapsed after it was filed, this action was brought for the recovery of the tax so paid.

The certificate (p. 2–3) sets forth the facts in No. 130 as follows:

This is a petition to review a decision of the United States Board of Tax Appeals. The petitioners are the executors of the will of William M. Wood, deceased. The Board of Tax Appeals found a deficiency in the Federal income tax of Mr. Wood for the year 1919 of $708,781.93 and for the year 1920 of $350,837.14. The petition for review was duly filed pursuant to sections 1001 and 1002 of the revenue act of 1926 and rule 38 of this court.

William M. Wood was president of American Woolen Company during the years of 1918, 1919, and 1920. In 1918 he received as salary and commissions from the company $978,725, which he included in his Federal income tax return for 1918. In 1919 he received as salary and commissions from the company $548,132.87, which he included in his Federal income tax return for 1919.

August 3, 1916, the American Woolen Company duly adopted the following resolution, which was in effect in 1919 and 1920:

"Voted: That this company pay any and all income taxes, State and Federal, that may hereafter become due and payable upon the salaries of all the officers of the company, including the president, William M. Wood; the comptroller, Parry C. Wiggin; the auditor, George R. Lawton; and the following members of the staff, to wit: Frank H. Carpenter, Edwin L. Heath, Samuel R. Haines, and William M. Lasbury, to the end that said persons and officers shall receive their salaries or other compensation in full without deduction on account of income taxes, State or Federal, which taxes are to be paid out of the treasury of this corporation."

This resolution was amended on March 25, 1918, as follows:

"Voted: That, referring to the vote passed by this board on August 3, 1916, in reference to income taxes, State and Federal, payable upon the salaries or compensation of the officers and certain employees of this company, the method of computing said taxes shall be as follows, viz:

"The difference between what the total amount of his tax would be, including his income from all sources, and the amount of his tax when computed upon his income excluding such compensation or salaries paid by this company."

Pursuant to these resolutions the American Woolen Company paid to the collector

of internal revenue Mr. Wood's Federal income and surtaxes due to salary and commissions paid him by the company as follows:

Taxes for 1918 paid in 1919	$681,169.88
Taxes for 1919 paid in 1920	351,179.27

The decision of the Board of Tax Appeals here sought to be reviewed was that the income taxes of $681,169.88 and $351,179.27 paid by the American Woolen Company for Mr. Wood were additional income to him for the years 1919 and 1920.

SUMMARY OF ARGUMENT

In No. 129 the payment of the tax by the lessee constituted a gain to the lessor produced by the leasing of its property, and was rent. In No. 130 the payment of the tax by the employer was in consideration of services rendered by the employee and was a gain derived by the employee from his labor. The form of the payment can make no difference and it is therefore immaterial that the taxes were directly paid over to the Government. The discharge of his obligation to a third person is equivalent to receipt by the taxable. This principle of constructive receipt is recognized in a line of consistent decisions by both Federal and State courts.

These cases are here upon a certificate which presents no basis for the contention that the theory of the Government will lead to an absurdity. No attempt has been made in these cases to press the theory to an absurd result. Properly speaking, the statute imposes no tax upon a tax. The diffi-

culty arises from the fact that the parties have made the tax a measure of income.

It is not necessary to resort to a complicated mathematical formula to compute the taxes in these cases, but, in any event, it has been repeatedly held that the science of mathematics is a proper subject for judicial notice and may be employed where necessary.

Unless the contention of the United States is approved, the way will be open for evasion of taxes.

ARGUMENT

I

THE PAYMENT OF TAXES BY THE LESSEE IN THE ONE CASE ON BEHALF OF THE LESSOR AND BY THE EMPLOYER IN THE OTHER CASE ON BEHALF OF THE EMPLOYEE RESULTS IN TAXABLE INCOME TO SUCH LESSOR AND EMPLOYEE

These cases involve an application of the principle of constructive receipt of income. The certificate shows that the taxes were *imposed* upon the lessor in the first case and upon the employee in the second case. It shows further that the taxes were actually *paid* by the lessee in the first case and by the employer in the second case. As further shown by the certificate, in the first case the lessee was under a duty to make the payment by reason of the terms of the lease, and in the second case the employee entered upon his duties in the years in question under the express agreement that his income taxes would be paid by his employer. This agreement is evidenced by the terms of the resolution

passed August 3, 1916, more than one year prior to the year in which the taxes were imposed (1918, 1919). Therefore, in the first case the taxes were paid by the lessee under the lease as part of the consideration for the use of the lessor's property; that is, as part of the rent reserved in the lease. In the second case the taxes were paid by agreement and upon a valuable consideration, namely, the services rendered by the employee and as part of the compensation therefor. Under such circumstances the payments constitute income to the lessor and employee, respectively.

There can be no doubt that if the lessee in No. 129 had paid to the lessor the amount which the latter was called upon to pay as taxes the money would be income in the hands of the lessor as a gain derived from the use of its property. *Hamilton* v. *Kentucky & I. Terminal R. Co.*, 289 Fed. 20. While to avoid circuity the money was paid directly to the Government by the lessee, that fact does not make it any the less income to the lessor. It can make no difference what form the payment takes, because it is clear that in substance and spirit the payment was in truth and reality a gain produced by the leasing of the property of the lessor. In No. 130 it is equally clear that the payment of the taxes was in consideration of the services rendered. Thus it was part of the compensation received, a gain derived from the labor of the employee. The District Court held in No. 129 that the lessor was not enriched by the payment and for that reason it

was not income. The same argument would apply if the tax money had been directly paid over to the lessor, but it must be apparent that the test is not whether the lessor might keep the money as actual profit. The true test is whether it is a gain produced by capital or labor. Because it is immediately spent for a designated purpose is of no significance in determining whether it is income. The circumstances under which it is received are the guide rather than the disposition thereafter made of it.

If these tax payments be income to the taxables—if the payment in No. 129 be a gain derived from the use of property and if the payment in No. 130 be a gain derived from the labor of the employee—it is of no consequence whether the payments were made directly to the taxables or to a third person to discharge a debt of the taxables. This is fundamental. The words of the statute also seem to support it. Section 213 of the Revenue Act of 1918 provides that the term gross income shall include *inter alia* income "of whatever kind and *in whatever form paid.*" As stated above, the taxes in No. 129 were paid by the lessee in consideration of the use of the lessor's property and in discharge of the lessor's tax obligation, while in No. 130 the taxes were paid by the employer in consideration of services rendered by the employee and in discharge of the employee's tax obligation. In each case this was equivalent to a receipt by the taxpayer. This principle has been recognized by the Board of Tax

Appeals in *Appeal of Providence & Worcester R. R. Co.*, 5 B. T. A. 1186, and *Houston Belt & Terminal Ry. Co.* v. *Commissioner*, 6 B. T. A. 1364.

The Board of Tax Appeals has not been alone in applying this principle. In *West End Street Ry. Co.* v. *Malley* (C. C. A. 1st), 246 Fed. 625, it was held that where a street railway company leased all its property to another operating company and the lessee agreed to pay as rental for the property the dividends on outstanding stock of the lessor, such payments were income to the lessor and subject to be taxed as income despite the fact that payments were made to the lessor's stockholders. This Court denied a writ of certiorari, 246 U. S. 671.

Under similar circumstances the Circuit Court of Appeals for the Second Circuit held that where the rental reserved in a lease was paid by the lessee directly to the stockholders of the lessor, the payments constituted income to the lessor. *Rennselaer & S. R. Co.* v. *Irwin*, 249 Fed. 726; certiorari denied, 246 U. S. 671. That court was clearly of the opinion that the arrangement between the parties for payment to a third person would not affect the essential character of the transaction and prevent the payment from being income to the lessor. This is evident from the following portion of the opinion (p. 727):

> It is true that the rent of its road does not go into the plaintiff's treasury and that it has no means of withholding the tax from it. It is also true that the rent reserved by the lease is paid by the lessee in fixed sums to

> third parties. All the same, the rent is the property of the plaintiff, and remains such, though by the terms of the lease paid out to others, whose rights are derived through it. While the rent is a debt of the lessee to the lessor, it is, as between the lessor and its stockholders, the lessor's income, out of which the dividends, if any, are to be paid.

In *Northern R. Co. of New Jersey* v. *Lowe* (C. C. A. 2d), 250 Fed. 856, the same conclusion was reached.

The principle is again illustrated in *Houston Belt & Terminal Ry. Co.* v. *United States* (C. C. A. 5th), 250 Fed. 1, where it was held that the payment of interest upon a mortgage debt upon property of the terminal company by four railroad companies which owned its stock was income to the terminal company. It was so held even though the railroad companies were liable for the interest and paid it directly to the mortgagee.

In *Blalock* v. *Georgia Ry. & Electric Co.* (C. C. A. 5th), 246 Fed. 387, it was held that rent under a lease which by agreement was paid directly to the lessor's stockholders was income to the lessor. In the opinion the court said (pp. 389, 390):

> * * * Is net rent paid for the use of corporate property made any the less corporate income received by the corporation, within the meaning of the provision just quoted, by the circumstances that, pursuant to a provision of the corporation's lease under which the rent is payable, it is paid to

> the corporation's then registered stockholders in amounts proportionate to their respective holdings of stock, instead of in a lump sum to the corporation itself? We think not. * * *
>
> * * * A creditor as truly receives payment of what is due him when, pursuant to his direction, the debtor makes payment to another, as he does when payment is made directly to himself.

Further support for this contention is found in *American Telegraph & Cable Co.* v. *United States,* 61 C. Cls. 326. In that case it was held that where one of the stockholders of a corporation guarantees certain dividends to the other stockholders by endorsement on their certificates and pays to certain stockholders their respective proportion of an agreed annual rental, which is secured by said guarantee of dividends, the rental so paid is income of the corporation and taxable as such. This Court denied certiorari, 271 U. S. 660.

This principle was held to be well established in *United States* v. *Western Union Telegraph Co.* (S. D. N. Y.), 19 F. (2d) 157, where a lessee had agreed to pay certain specific sums annually to the individual stockholders for the use and occupancy of the lessor's property. The court there said (p. 158):

> It is too well established to be questioned that all the payments made and to be made by the Western Union Telegraph Company to the stockholders of the Northwestern

Telegraph Company under the foregoing agreements must be held to constitute taxable income of the Northwestern Telegraph Company. *Rensselaer & S. R. Co.* v. *Irwin* (C. A. C.) 249 F. 726, certiorari denied 246 U. S. 671, 38 S. Ct. 424, 62 L. Ed. 931; *Northern R. Co. of New Jersey* v. *Lowe* (C. C. A.) 250 F. 856. See also, *Houston Belt & Terminal Ry. Co.* v. *United States* (C. C. A.) 250 F. 1; *Hamilton* v. *Kentucky & I. Terminal Ry. Co.* (C. C. A.) 289 F. 20; *American Telegraph & Cable Co.* v. *United States,* 61 Ct. Cls. 326, certiorari denied April, 1926, 271 U. S. 660, 46 S. Ct. 473, 70 L. Ed. 1137; *West End Street Ry. Co.* v. *Malley* (C. C. A.) 246 F. 625, certiorari denied 246 U. S. 671, 38 S. Ct. 423, 62 L. Ed. 931.

That the principle is also recognized in the State courts is evident from the case of *Estate of Levalley,* 191 Wis. 356. In that case a testator had provided for the payment of estate taxes out of his estate and it was held that the right of the legatee to receive his legacy free from tax gave him an interest in the estate over, above, and beyond the legacy actually received and constituted a transfer of an additional interest in the estate.

To the same effect was the holding in *Estate of Irwin,* 196 Cal. 366, where, under similar circumstances, it was held that the legatee was bequeathed an additional amount sufficient to pay the tax.

Upon the authority of these consistent decisions of both Federal and State courts, we think it is now

settled that the difference between payment of rent to the lessor and payment of the rent direct to a third party for the benefit of the lessor is one of method and not of substance. Taxation is a practical matter, and the Revenue Acts were designed to operate in a practical world. It is clear that, looking through the form and having due regard for the substance, the taxes in these cases, though paid directly to the collector, were nevertheless gain derived by the taxables. We therefore submit that the payment by the lessee in No. 129 and by the employer in No. 130 of the income taxes assessed against the lessor in the first case and the employee in the second case constitutes taxable income to such lessor and to such employee.

Duffy v. *Pitney,* 2 F. (2d) 230, is not inconsistent in principle with the cases cited above. That case involved tax-free covenant bonds and held that the payment by the debtor corporation of the 2% tax upon bond interest was not income to the bondholder.

However, the tax was withheld at the source in obedience to the statute and the corporation in paying the tax was discharging a duty cast upon it by the statute. The corporation was not permitted to deduct it in ascertaining its own net income. In effect it was paying its own tax. Furthermore, the case was decided after the enactment of the Revenue Act of 1921, c. 136, 42 Stat. 227, 254, which declared in Section 234(a) (3) "nor shall such tax be in-

cluded in the gross income of the obligee." This action by Congress was referred to in the decision then under review (291 Fed. 621, 625) as "indicative of its desire to make it clear that it was not taxing citizens upon a fiction but upon their income." In the instant cases it is clear that the taxes were imposed upon the lessor and the employee and that the statute cast no duty upon either the lessee or the employer. Accordingly, it is apparent that *Duffy* v. *Pitney, supra,* distinguishes itself and presents no conflict with the cases upon which we rely.

Nor does the case of *Matter of Estate of Swift,* 137 N. Y. 77, establish that the principle for which we contend is not recognized in New York. In that case the question was whether the collateral inheritance tax law of New York was enforcible as to property which at the time of the death of the testator was outside the territorial limits of the state. The following language of the opinion clearly distinguishes that case (pp. 82–83):

> * * * Could anyone say, after reading the provisions of this law, that it was the legatee, or person entitled, who was taxed? I doubt it. Property, which was the decedent's at the time of his death, is subjected to the payment of a tax. The tax is to be deducted from the legacy; or, when deduction is not possible from the legacy not being in money, and a collection from the legatee or the person entitled to the property is author-

> ized to be made, the tax so to be collected is described as *"the tax thereon,"* that is, on the property.
>
> If it should be said that such an interpretation of the law is in conflict with the doctrine which some judges have asserted, respecting the nature of this tax, I think it might be sufficient to say that the phraseology of the New York law differs, more or less, from that of other states, and seems peculiarly to charge the subject of the succession with the payment of the tax. But I do not think it at all important to our decision here that we should hold it to be a tax upon property precisely.

The court was clearly of opinion that the tax was not a charge upon the legatee. Naturally, under that view, the tax could not enlarge his bequest, so that the case is not helpful in determining whether the payment of a person's tax by another constitutes income to the taxable.

Nor can it be argued that the payment of the tax in No. 130 was a gift. That payment for services, even though in the form a gratuity, is compensation within the statute is illustrated by the case of *Noel* v. *Parrott* (C. C. A. 4th), 15 F. (2d) 669. In that case, the directors of a corporation, in contemplation of the sale of all the stock and assets of the company, and the consequent resignation of its officers, and in view of the long and faithful services of its officers as well as their services in the sale of assets, passed the following resolution (p. 669):

> Resolved, that a gratuitous appropriation equal in amount to $3 per share on the outstanding stock of the company be set aside out of the assets *for distribution to certain officers and employees* of the company and that the executive committee be authorized to make such distribution as they deem *wise and proper.*

The executive committee directed that $35,000 be paid to the plaintiff taxpayer. The court said, at page 672:

> *In no view of the evidence, therefore, can the $35,000 be regarded as a gift. It was either compensation for services rendered,* or a gain or profit derived from the sale of the stock of the corporation, or both; *and, in any view, it was taxable as income.* (Italics supplied.)

In view of the foregoing, we submit that the question presented by the certificate should be answered in the affirmative.

II

THERE IS NO MERIT TO THE TAXPAYERS' CONTENTION THAT THE THEORY OF THE GOVERNMENT WILL LEAD TO AN ABSURDITY

The taxpayers contend that if these payments by the lessee and employer constitute income to the lessor and the employee, the lessee and employer will be called upon to pay the tax imposed upon this additional income and that the payment of the additional tax will create further income which will

in turn be subject to tax, with the result that there would be a tax upon a tax. They urge that the Government's theory, when carried to its logical conclusion, results in an absurdity which Congress could not have contemplated.

There are two reasons why this argument can not prevail. In the first place, no attempt has been made by the Treasury to collect further taxes, upon the theory that the payment of the additional taxes creates further income, and the question of a tax upon a tax was not before the Circuit Court of Appeals and has not been certified to this Court.[1] It will be time enough to complain of compounding taxes when an attempt to do so is made. See *United States* v. *Sullivan*, 274 U. S. 259. This Court is now dealing only with the cases in hand, and whether absurd results will follow in imaginary cases is not a matter for present consideration. As stated in *Yazoo & Mississippi R. R.* v. *Jackson Vinegar Co.*, 226 U. S. 217, 219:

> * * * this court must deal with the case in hand and not with imaginary ones. It

[1] The certificate shows (p. 2) that the payment of the lessor's initial tax of $61,422.06 was held by the Commissioner to constitute additional income upon which a tax of $3,920.55 was paid, and for the recovery of which the action in No. 129 was commenced.

With respect to No. 130, the certificate shows (p. 2–3) that the employee's executors took an appeal from the Commissioner's determination that the initial taxes paid by the employer constituted additional income to the employee.

> suffices, therefore, to hold that, as applied to cases like the present, the statute is valid. How the state court may apply it to other cases, whether its general words may be treated as more or less restrained, and how far parts of it may be sustained if others fail are matters upon which we need not speculate now.

We assume that the contention will be made here, as in the court below, that the Treasury would have no right to stop with one computation as it did in these cases and fail to assess further taxes *ad infinitum* upon the theory that each payment of tax created further income. This contention, which amounts to a complaint by the taxpayer that he has been taxed too little, has, at least, the merit of novelty. However, we think that in a case where the parties have placed themselves in such a position that extreme hardship will follow the literal application of a principle, the Treasury Department is not fairly to be censured if it fails to apply its theory literally in order to avoid absurd consequences. The limited application which has been given to the theory in these cases leads to no absurdity and the question now before this Court is circumscribed by the general rule that it is sufficient if a statute is valid as applied to the case in hand. The question of where to draw the line is one which need not trouble the Court. *Irwin* v. *Gavit*, 268 U. S. 161, 168.

In the second place we contend that, properly speaking, there can be no question of a tax upon a tax being imposed by Congress. If the payment of the tax creates income, then any further tax would be imposed upon such income solely because it was income and the fact that the money treated as income was in reality used to pay taxes does not result in levying a tax upon a tax. In enacting the Revenue Acts Congress merely imposed these taxes upon income. It had nothing to do with the resolution of the Board of Directors of the American Woolen Company or with the lease entered into by the Fitchburg Railroad Company and the Boston & Maine Railroad. The difficulty arises from the agreement of the parties, not from the law. The United States does not care who ultimately bears the weight of the tax, but if through arrangement between the parties the payment of the tax results in further income, it is a result which flows from the acts of the parties and not from the imposition of the initial tax. The parties, of course, were under the practical difficulty of not being able to calculate the amount of tax for each year of the agreement and for that reason provision for paying the taxes was made by the blanket clause in the lease and in the resolution. However, if in lieu of that general provision the lease had provided for payment of $61,422.06 to cover the tax of the Fitchburg R. R. Co. for the year involved and if the resolution had provided for the payment of the exact amount of

the tax of Mr. Wood, and further if the Fitchburg R. R. Co. and Mr. Wood had included such payments in their original returns for the years involved, this question of compounding the tax would not have arisen.

> * * * It could not well be doubted that, had they been beforehand fixed in amount, they would properly be treated as income. That these amounts were uncertain until fixed by experience does not alter their essential nature. [*Hamilton* v. *Kentucky & I. Terminal R. Co.*, 289 Fed. 20, 23.]

It is therefore submitted that the statute does not impose any tax upon a tax, but that the whole question is injected into these cases solely by reason of the acts of the parties themselves. They have made the tax a measure of income and Congress has made income the measure of the tax.

A similar argument was made to the Wisconsin court in the case of *Estate of Levalley,* 191 Wis. 356, 359, and was disposed of by the court in the following language:

> * * * it is argued that if the statute be so construed it results in a payment of a tax upon a tax. This is not strictly true. While it is true in the supposed case that $7,879 goes to the state and not to the legatee, it is equally true that a tax is reckoned upon the whole amount of a legacy, including that part of it necessary to pay the tax when the tax is not payable from the residue and is deducted

from the legacy. There is no more a tax upon a tax in the one case than in the other.

This would seem to dispose of the contention that the Government's theory results in an absurdity.

III

IT IS NOT NECESSARY TO RESORT TO A COMPLICATED MATHEMATICAL FORMULA TO COMPUTE THE TAXES IN THESE CASES. NEITHER DOES EDWARDS *v.* SLOCUM CONDEMN THE USE OF SUCH FORMULÆ WHEN NECESSARY

It is further objected that the computation of the tax presents a difficulty which can only be solved by resort to an algebraic formula, and much reliance has been placed upon the expression of this Court in *Edwards* v. *Slocum,* 264 U. S. 61, 63:

> * * * It fairly might be answered, as said by the Circuit Court of Appeals, that "algebraic formulæ are not lightly to be imputed to legislators," but it appears to us that the structure of the statute is sufficient to exclude the imputation.

If the payments of the lessor's and employee's taxes by the lessee and employer, respectively, be income, we submit that if necessary the Treasury Department has an undoubted right to make use of whatever branch of mathematical science is applicable for the determination of the tax upon it. This Court did not say in the *Slocum case, supra,* that where income can only be correctly calculated and clearly reflected by algebraic formulæ, that such formulæ are nevertheless conclusively presumed to

be beyond the ken of Congress. *Humes* v. *United States,* 276 U. S. 487, rather indicates that the true test is whether there are known data upon which to base some standard, recognized method of calculation. The Government is not to be deprived of its tax because the parties have made the tax a measure of income. No court has ever denied the resort to mathematics wherever it becomes necessary. On the contrary, it has been many times held by the courts that the science of mathematics is a proper subject for judicial notice and calculations based on various branches of this science have been frequently employed and their use judicially justified. See *Wyldes* v. *Patterson,* 31 N. D. 282; *Scanlan* v. *San Francisco & S. J. V. Ry. Co.,* 55 Pac. 694.

The use of mortality tables is well recognized and this Court has evidenced its approval of their employment. See *Simpson* v. *United States,* 252 U. S. 547, 550.

See also *Cochran* v. *United States,* 254 U. S. 387, 390; *Appeal* of *Providence & Worcester R. R. Co.,* 5 B. T. A. 1186; *Boston & Maine R. R.* v. *United States,* 23 F. (2d) 343; and *Wood, Administrator,* v. *Chapman,* 87 Okla. 49.

We think the cases sufficiently establish our contention that if the occasion demands it resort may be had to any approved method of calculation. In our view, however, this tax can be computed in a more simple manner than suggested by the taxpayers. The following example is calculated

only with reference to the normal tax, eliminating any excess-profits tax calculations. Let us suppose that the agreed amount of rent to be paid over each year was $94,000. The tax rate for 1917, the year involved in the case at bar, was 6%. The total taxable income of the lessor would therefore be not $94,000 but $94,000, plus a sufficient amount of money to pay an income tax at 6% on a total taxable income which would net the lessor $94,000. No involved algebraic formulae are necessary to solve this problem.

If 100% represents the total net taxable income of the lessor, and the tax rate is 6%, then 94% must represent the net amount of cash turned over to the lessor by the lessee. That is to say:

100% = Total net taxable income,
6% = Tax rate,

94% = $94,000, net amount of cash turned over by lessee to lessor.

Therefore:

$94,000 ÷ 94% = $100,000—Total net taxable income,
6% = 6,000—Tax liability of lessor.

However, the lessee, in arriving at the amount that it should withhold from the total taxable income to pay the tax on behalf of the lessor, did not first determine the total rent due from it to the lessor; but, determined lessor's tax liability by multiplying the net amount turned over to the lessor, or $94,000, by 6%, as follows:

$94,000 × .06 = $5,640.

The lessee thus determined the lessor's tax liability to be $5,640 instead of $6,000, the true amount. This error in the principle of the calculation brought into play a more complex computation. The $5,640 being additional income over and above the said $94,000, the lessor was liable to an income tax thereon, the amount of which the lessee was obligated to pay to the lessor or nominee as a part of the consideration for the lease. So that we find the lessee's method of determining the rent due from it to the lessor leading to the following:

$94,000.00×.06=	$5,640.00
5,640.00×.06=	338.40
338.40×.06=	20.30
20.30×.06=	1.22
1.22×.06=	.08
.08×.06=	.00
$100,000.00	$6,000.00

The greater simplicity of the previous calculation is obvious and it is equally applicable to the employee in No. 130. If we are correct that the taxes paid for them should be included in their income, then it becomes clear that these taxpayers have built their whole pyramid upon the wrong foundation.

IV

EVASION OF INCOME TAX OBLIGATIONS WOULD RESULT IF PAYMENT OF TAX BY THIRD PERSONS WERE NOT TAXED AS INCOME TO PERSON FOR WHOM PAID

Finally, we wish to point out that if a corporation can pay the income tax of its employees without

the amount of the tax being included as income to the employee, it will result in evasion of taxes. While we do not suggest any such intention in the instant cases, it is clear that unless the contention of the Government is approved, the door will be open for evasion. It would be a simple matter in all cases for an employer and employee to agree upon a salary, calculate the amount of tax thereon, reduce the amount of the salary by the amount of the calculated tax, and then have the employer pay the tax upon the reduced basis. The Government would lose the difference between the tax on the full salary and the tax on the reduced salary. An adjustment of the gain between employer and employee could be made with advantage to both, but it is clear that it would be at the expense of the Government. The practical result would be to permit the employee to deduct the amount of his tax from his salary in computing his net income, which is contrary to the provisions of the Act. (Revenue Act of 1918, Section 214 (a) (3).)

In *Estate of Irwin, supra,* the California court perceived a similar opportunity. At page 376 the court said:

> * * * It is at once apparent that upon appellants' theory that the tax is to be computed only upon the bequest as specified in actual figures in the will and upon the residuum after the deduction of the payment of the tax upon the bequest of $100,000, that no tax would be computed upon the money

left by the testatrix to be applied to the payment of the inheritance tax upon the various bequests. By this means a testator by a direction to pay all inheritance taxes out of the residue could defeat the payment to the state of the tax on a very substantial part of his estate.

This reasoning applies with equal force to the situation presented by these cases.

CONCLUSION

It is respectfully submitted that the question certified by the Circuit Court of Appeals should be answered in the affirmative.

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